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Canadian Income Tax Law: Cases, Text, and Materials

Volume I

David G. Duff
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Part I

Introduction

Division C of Part I of the Act, which comprises sections 110 to 114.2, sets out a number of additions and deductions for the purpose of computing a taxpayer's taxable income. For our purposes, the key provisions in this Division are paragraph 110(1)(d) (providing a deduction for certain kinds of employee stock options), paragraph 110(1)(f) (allowing taxpayers to deduct, among other things, social assistance payments and workers' compensation), paragraph 110(1)(h) (allowing taxpayers to deduct specific amounts included in their income in respect of a home relocation loan), section 110.1 (which allows corporations to deduct the value of certain kinds of gifts), section 110.6 (which allows individuals to deduct a cumulative lifetime amount with respect to capital gains arising on the disposition of certain kinds of property), section 110.7 (providing a special deduction for persons resident in northern parts of Canada), and section 111 (which allows individual and corporate taxpayers to deduct losses from certain other taxation years which may be "carried over" to the taxation year for which taxable income is computed).[2] These provisions are examined in chapter 14, *infra*.

(2) Net Income

The rules governing the computation of a taxpayer's income for the year are found in Division B of Part I of the Act, comprising sections 3 to 108. According to the "basic rule" in section 3, the income of a taxpayer for a taxation year is determined by applying various rules, the essence of which is contained in paragraphs (a), (b), (c) and (d). Following the verbal formula set out in these provisions, the taxpayer's income for the year is the amount by which the sum of the amounts determined in paragraphs 3(a) and (b) exceeds the amounts described in paragraphs 3(c) and (d). In other words, the taxpayer's income for the year is the amount determined in paragraph 3(a) plus the amount determined in paragraph 3(b) minus the amounts described in paragraphs 3(c) and (d). On the federal income tax return, this amount is referred to as "net income". Where this amount is a positive amount, paragraph 3(e) defines "the amount so determined" as "the taxpayer's income for the year". Where this amount is negative, paragraph 3(f) deems the taxpayer "to have income for the year in an amount equal to nil." Thus, it is impossible for a taxpayer to have negative income for taxation year.[3]

Paragraph 3(a) refers to "the total of all amounts each of which is the taxpayer's income for the year (other than a taxable capital gain from the disposition of a property) from a source inside or outside Canada, including, without restricting the generality of the foregoing, the taxpayer's income for the year from each office, employment, business and property". The rules governing income or loss from an office or employment are found in

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[2]Until 1988, Division C also contained a number of personal and other deductions (e.g., for charitable contributions, medical expenses, disability, education, and tuition) available to individuals. In 1988 these deductions were repealed and replaced with tax credits which are currently found in sections 118 to 118.9.

[3]As explained below in subsection (2), unutilized losses that would otherwise result in negative income for the taxpayer's taxation year may, under section 111 be carried over to be deducted in computing a taxpayer's taxable income in certain other taxation years.

sections 5 to 8, which together constitute Subdivision a of Division B of Part I the Act.[4] Subdivision b of Division B of Part I, comprising sections 9 to 37.3 of the Act, contains rules governing the income or loss from a business or property.[5] Subdivision d of Division B of Part I (sections 56 to 59.1) specifies various other amounts which must be included in a taxpayer's income.[6]

Paragraph 3(b) contains the basic rule by which "taxable capital gains" (which are explicitly excluded from the amount determined in paragraph (a)) are included in a taxpayer's income for the year. According to this paragraph, a taxpayer's income for the year includes, in addition to the amounts determined in paragraph 3(a), the amount, if any, by which the total of the amounts defined by clauses (A) and (B) exceeds the amount described in subparagraph (ii) -- in other words, the amount defined by clause (A) plus the amount defined by clause (B) minus the amount described in subparagraph (ii). Although the Act does not use the expression, this amount may be thought of as the taxpayer's net taxable capital gain for the year.[7] For present purposes, there is no need to examine the amounts described in paragraph 3(b) in any detail, except to note the effect of paragraph 3(b) which is that the amount described in subparagraph 3(b)(ii) can be subtracted only from the amount defined in subparagraph 3(b)(i). In general, this means that capital losses for a taxation year can be deducted only against capital gains for that taxation year.[8] The rules governing taxable capital gains and allowable capital losses are found in Subdivision c of Division B of Part I, comprising sections 38 to 55 of the Act.[9] Section 38 stipulates that the "taxable" portion of a capital gain and the "allowable" portion of a capital loss is three-quarters of the gain or loss otherwise determined.[10]

In computing a taxpayer's income for a taxation year, paragraph 3(c) provides for the deduction of "the total of the deductions permitted by subdivision e" -- "except to the extent that those deductions, if any, have been taken into account in determining the total referred to in paragraph (a)". Subdivision e of Division B of Part I comprises sections 60 to 66.8 of the Act, which allow taxpayers to deduct various amounts as stipulated, for example moving expenses, child care expenses, and support payments.[11] Some of these amounts, however, may also be deductible in computing a taxpayer's income for the year

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[4]See *infra* chapters 5 and 10.

[5]See *infra* chapters 6, 8 and 11.

[6]See *infra* chapters 9 and 13.

[7]This term is used in Vern Krishna, *The Fundamentals of Canadian Income Tax*, 5th edn. (Scarborough: Carswell, 1995) at 444.

[8]There are two exceptions to this rule. First, as paragraph 3(d) indicates, "allowable business investment losses" (a special kind of capital loss) may be deducted against income from all sources. Allowable business investment losses are explicitly excluded from the loss limitation rule in paragraph 3(b) under subparagraph 3(b)(ii). Second, under paragraph 111(1)(b), "net capital losses" may be carried over to certain other taxation years and deducted from net taxable capital gains in those years. This carryover is examined in subsection (2) below on the accounting period of the income tax.

[9]See *infra* chapters 7 and 12.

[10]From 1972 to 1987, this fraction was one-half. In 1988 and 1989, it was two-thirds. The current "inclusion rate" has been in effect since 1990. See *infra* chapter 12.

[11]See *infra* chapter 13.

from a source contemplated in paragraph 3(a).[12] In these circumstances, paragraph 3(c) stipulates that these amounts are to be deducted in computing the taxpayer's income from the specific source to which the deduction relates, not under paragraph 3(c).[13]

Finally, paragraph 3(d) provides for the further deduction in computing a taxpayer's income from a taxation year of "the total of all amounts each of which is the taxpayer's loss for the year from an office, employment, business or property or the taxpayer's allowable business investment loss for the year." Thus, unlike most allowable capital losses for a taxation year, which are deductible only against taxable capital gains for the taxation year, losses from an office, employment, business or property and allowable business investment losses may be deducted from a taxpayer's income from all other sources in computing the taxpayer's net income for the taxation year.

(3) Income

Although section 3 stipulates the manner in which "the income of a taxpayer for a taxation year" is to be determined, neither it nor any other provision of the Act defines the word "income". Consequently, as the Supreme Court of Canada stated in *Curran* v. *M.N.R.*, [1959] C.T.C. 416, 59 D.T.C. 1247 (S.C.C.), the word "must receive its ordinary meaning bearing in mind . . . the ordinary concepts and usages of mankind."[14]

According to *The Concise Oxford Dictionary*, "income" is defined as the "periodical (usu. total annual) receipts from one's business lands, work, investments, etc."[15] The word "capital", on the other hand, is defined in terms of a "stock" of accumulated wealth or value,[16] while "consumption" is defined as the "purchase and use of goods etc.".[17] On this basis, therefore, one might distinguish an income tax which applies to the *flow* of a taxpayer's "receipts" *over a specific period of time* (typically a

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[12]In computing a taxpayer's income from an office or employment, from a business, or from property, specific deductions may be permitted under the provisions of subdivisions a and b. See *infra*, chapters 10 and 11. In addition, as Chapter 11 explains, amounts that are not specifically identified in the Act may be deducted in computing the "profit" from a business or property under subsection 9(1) of the Act. The relationship between the deduction of amounts under subdivision e and the deduction of the same amount in computing a taxpayer's income from a source is considered in *Symes* v. *R.*, [1994] 1 C.T.C. 40, 94 D.T.C. 6001 (S.C.C.). See *infra* chapter 13.

[13]See also paragraph 248(28)(a) [formerly subsection 4(4)], according to which: "Unless a contrary intention is evident, no provision of the Act shall be read or construed . . . to . . . permit the deduction . . . in computing a taxpayer's income . . . for a taxation year . . . of any amount to the extent that the amount has already been . . . deducted . . . in computing such income . . . for the year". Unlike paragraph 248(28)(a), which provides only that an amount shall not be deducted twice, paragraph 3(c) stipulates that an amount which may be deductible under subdivision e or in computing a taxpayer's income from a source shall be deducted in computing the taxpayer's income from the source.

[14]See also *Wood* v. *M.N.R.*, [1969] C.T.C. 57, 69 D.T.C. 5073 (S.C.C.): "Income is to be understood in its plain ordinary sense and given its natural meaning."

[15]*The Concise Oxford Dictionary*, 7th edn. (Oxford: Clarendon Press, 1982) at p. 506.

[16]*Ibid.* at p. 136.

[17]*Ibid.* at p. 203.

year), from a *capital or wealth tax* which applies to the *stock* of capital or wealth held by a taxpayer *at a particular point in time* and a *consumption or expenditure tax* which applies to a particular *use* of the taxpayer's income or capital *to purchase goods and services*.[18] As well, it would seem, one might distinguish income from other receipts such as gifts and inheritances on the basis that the former are *periodical* receipts "recurring at regular intervals",[19] while the latter are generally irregular or non-recurring.

Although Canadian courts do not appear to have found it necessary to distinguish between income and consumption for the purpose of applying the income tax, several cases have emphasized the distinction between income and capital. In *Shaw* v. *M.N.R.*, [1938-39] C.T.C. 346 (S.C.C.), for example, where the taxpayer received monthly payments of $700 under a contract of life insurance for which her late husband had paid cumulative premiums exceeding $37,000, the Court held that the monthly payments were on account of capital, not income within the meaning of section 3 of the *Income War Tax Act*, S.C. 1917, c. 28, which included among other amounts the taxpayer's "annual net profit or gain or gratuity" from various sources, "the income from but not the value of property acquired by gift, bequest, devise or descent", and "the income from but not the proceeds of life insurance policies paid upon the death of the person insured". Rejecting the Minister's argument that the full amount of each payment was income to the taxpayer, Duff, C.J.C. concluded that:

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[18]Although the federal government and several provinces impose corporate capital taxes, and provincial and municipal governments levy real poperty taxes, Canada does not have a broad-based capital or wealth tax like the "annual net wealth taxes" imposed in several European countries. In contrast, the federal government and all provinces but Alberta levy broad-based consumption or expenditure taxes in the form of value-added or retail sales taxes, and most of these governments impose so-called excise taxes on the consumption of specific goods (e.g. alcohol, tobacco and gasoline). While taxes on consumption or expenditure are typicially levied in the form of sales or excise taxes imposed at the point of sale, such taxes might also be based on a taxpayer's consumption over a period of time (e.g. a year) by allowing taxpayers to deduct all savings from income otherwise taxable under an income tax. Indeed, to the extent that specific features of the existing income tax reduce or eliminate tax on certain kinds of savings (e.g. retirement savings), it is often argued that the existing "income tax" is actually a hybrid income-consumption tax. On the taxation of capital or wealth, see Organization for Economic Co-operation and Development, *Taxation of Net Wealth, Capital Transfers and Capital Gains of Individuals*, (Paris: O.E.C.D., 1988); James Cutt, "A Net Wealth Tax for Canada?" (1969), 17 *Can. Tax J.* 298; Alex C. Michalos, "The Case for a Progressive Annual Net Wealth Tax" (1988), 2:2 *Public Affairs Quarterly* 105; and Robert D. Brown, "A Primer on the Implementation of Wealth Taxes" (1991), 17 *Can. Pub. Pol'y* 335. On the taxation of consumption in the form of sales and excise taxes, see Satya Poddar and Morley English, "Fifty Years of Commodity Taxation: Key Events and Lessons for the Future" (1995), 43 *Can. Tax J.* 1096, and Sijbren Cnossen, "VAT and RST: A Comparison" (1987), 35 *Can. Tax J.* 559. On the theory of a hybrid income-consumption tax, see Henry J. Aaron, Harvey Galper, and Joseph A. Pechman, eds., *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax*, (Washington, D.C.: Brookings Institution, 1988); and Edward McCaffery, "Tax Policy Under a Hybrid Income-Consumption Tax," 70 *Texas L. Rev.* 1145 (1992). On the relative merits of income and consumption taxation, see William D. Andrews, "A Consumption-Type or Cash Flow Personal Income Tax," 87 *Harv. L. Rev.* 1113 (1974); Alan Gunn, "The Case for an Income Tax," 46 *U. Chi. L. Rev.* 370 (1979); Alvin Warren, "Would a Consumption Tax Be Fairer Than an Income Tax?" 89 *Yale L.J.* 1081 (1980); and Charles R. O'Kelley, "Rawls, Justice, and the Income Tax," 6 *Georgia L. Rev.* 1 (1981).

[19]See the definition of "periodic" in *The Concise Oxford Dictionary*, *supra* at p. 763.